

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE (619) 236-6220
FAX (619) 236-7215

Michael J. Aguirre
CITY ATTORNEY

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REPORT TO THE HONORABLE
MAYOR AND CITY COUNCIL

**AMENDMENTS TO THE SAN DIEGO MUNICIPAL CODE ELIMINATING THE
DEFERRED RETIREMENT OPTION PLAN [DROP]**

The Deferred Retirement Option Plan [DROP] program was created on March 4, 1997, via adoption of O-18385. That ordinance provided:

24.1401 Purpose and Intent

- a. A deferred retirement option plan (DROP) is hereby established effective April 1, 1997. The DROP plan is intended to allow Members who are eligible for service retirement to voluntarily elect an option to: (1) irrevocably waive their right to continue as a Member, (2) defer termination of City service for the duration of participation in DROP, and (3) defer receipt of their retirement allowance (calculated as of the date Membership status is waived) for the duration of participation in DROP.
- b. It is also intended that the provision of this Division shall not in any way jeopardize the qualified status of the Retirement System under the rules and regulations of the Internal Revenue Service.
- c. It is further intended that the Members of the Retirement System shall vote upon the establishment and implementation of this DROP benefit as a conditional benefit for a three-year trial basis. Election materials to the Members shall reflect the conditional nature of this benefit by clearly explaining that after three years of implementation the cost of implementing this benefit shall be evaluated by the actuary for the Retirement System. If it is determined that implementation of DROP has the net effect of increasing the City's contributions to the Retirement System to a level greater than the savings realized by the elimination of employer contributions and the City's offset of employee contributions, then the City Council shall consider amendments to this Division to eliminate the availability of DROP for new participants. Council's action to prospectively eliminate the benefit, should that occur, shall not be subject to a vote of the Membership. If the determination of the Actuary is that DROP does not have the net effect of increasing the City's contributions to the Retirement System to a level greater than the savings realized by the

elimination of employer contributions and the City's offset of employee contributions, the DROP benefit shall no longer be considered conditional and shall be treated the same as any other defined benefit of the Retirement System.¹

Only 27 days later on March 31, 1997, ordinance number O-18392 repealed ordinance number O-18385 and further provided:

24.1401 Purpose and Duration

a. Effective April 1, 1997, a deferred retirement option plan (DROP) is created and offered to Members on a voluntary basis as an alternative method of benefit accrual in the Retirement System as set forth in this Division.

b. DROP is created to add flexibility to the Retirement System. It provides Members who elect to participate in the program access to a lump sum benefit in addition to their normal monthly retirement allowance at their actual retirement. DROP is intended to be cost neutral regarding plan funding.

c. The DROP plan shall be offered on a trial basis for a period of three years commencing April 1, 1997 and ending March 31, 2000. During this three year trial period, DROP shall be evaluated by the City on a cost basis. During and by the end of this three year period, the city will determine whether the costs of DROP, including but not limited to any increase to the employer contribution rate recommended by the System's actuary specifically related to DROP, are greater than any savings realized as a result of the implementation of DROP. If the City determines DROP to not be cost effective, the City may determine not to extend DROP for elections that would otherwise have been made by Members after April 1, 2000. If the City determines DROP to be cost effective, or takes no action to eliminate further DROP participation, DROP shall become a permanent benefit effective April 1, 2000.

The quick repeal and reinstitution of the DROP program with differing language by Ordinance number 18392 apparently was as a consequence of the City's labor negotiations with its then four recognized employee labor organizations.² The difference between the initial March 4, 1997 ordinance and subsequent March 31, 1997 ordinance is significant in semantics, but not in underlying purpose, intent and basis. The initial version makes it clear that absent the completion of an SDCERS actuarial study of cost-neutrality, it shall not continue beyond the three year trial period. The importance of this actuarial study is reaffirmed in the subsequent

¹ Ordinance Number 18385, adopted on March 4, 1997, at page 2. (Attached hereto as Exhibit 1).

² Ordinance Number 18392, adopted on March 31, 1997, at page 2. (Attached hereto as Exhibit 2).

ordinance wherein it also mandates such a study. The essential prerequisite of cost-neutrality to continuation of the DROP program as stated in the initial ordinance remains and is reiterated in the subsequent ordinance by authorizing the City Council to eliminate the program after the trial period if it is not.

Similarly, the language of the subsequent ordinance seemingly enabling the DROP program to continue in the event of City inaction does not alter the foregoing fundamental dictate of an actuarial cost study and requirement of cost neutrality. To read this language in isolation as such would render the remainder of both the initial and subsequent ordinances requiring both actuarial studies and a finding of cost-neutrality nullities. Further, it would allow continuation of a benefit regardless of cost and resulting fiscal detriment to the City and/or Retirement System, a nonsensical result. Such would be violative of law, at odds with actuarial principles and constitute an impermissible gift of public funds. Moreover, a reading of this provision in isolation would be wholly at odds with the subsequent documentary record as detailed more fully herein below wherein many documents were generated with inquiry, concern, response and opinion as to both the cost of the DROP program and its dubious continuance in the absence of the required showing of cost neutrality.

As set forth in Section 24.1401(c), DROP was created for a three-year trial period.³ Its continuation was conditional on an actuary's determination that it was cost-neutral to the City. In the absence of such an actuarial determination, the ordinance required that Council consider amendments to eliminate the DROP program. The three year trial period expired without the requisite cost-neutral actuarial determination having been made. Therefore in March 2000, the Council should have considered amendments to eliminate the DROP program. It did not do so.

What Council did do was take affirmative action to extend the trial basis of the DROP program for one year. In closed session before Council on March 21, 2000, the City's Labor Negotiations team requested another year for SDCERS to analyze the cost of the DROP program.⁴ Council acquiesced in this request. However, this additional year also passed without any actuarial evaluation being conducted as required by the ordinance and the very reason for the proffered one year extension to the DROP program.

In 2002, two years after expiration of the three-year trial period, Section 24.1401 was amended to set forth the permanency of the DROP program retroactive to April, 2000. Research of the documented history of the 2000 to 2002 time period again reveals that no cost-neutral evaluation was conducted by any actuary, in which it was concluded that the DROP program was cost-neutral to the City. To the contrary and as set forth below, all actuarial studies undertaken concluded that the DROP program was not cost-neutral.

³ See also, City of San Diego memo "Deferred Retirement Option Plan (DROP)", dated 8/98. (Attached hereto as Exhibit 3).

⁴ See Closed Session Report dated March 21, 2000 and Power Point presentation attached thereto. (Attached hereto as Exhibit 4).

In addition to the lack of a cost-neutral determination, the documentary history is clear both as to the precept of cost-neutrality for continuation of the DROP program beyond the trial period and that the DROP program was not cost-neutral.

SDCERS ACTUARY CONDUCTED AN EVALUATION OF DROP IN 1999 AND DETERMINED THAT DROP WAS NOT COST NEUTRAL

On June 17, 1999, Gabriel, Roeder, Smith & Company [Roeder] performed a detailed cost analysis of DROP. The report was entitled "Evaluating the Financial Impact of DROP / City of San Diego" and was dated June 17, 1999 and couched as a second draft.⁵ In that nineteen page report, Roeder identified the six criteria upon which the City's DROP program should be evaluated for determining whether or not DROP is cost neutral. Each of these six items were evaluated as to whether they provided a cost or savings to the annual contribution required by the City. Each of the six items was quantified by a specific dollar amount. After quantifying each of these six items, Roeder concluding that under the total impact method, and using the weighted employee approach, the City's DROP program had resulted in a cost of \$3,686,800 to the City since the inception of the DROP program on April 1, 1997 through and including June 30, 1998, a little over a year after DROP was implemented.⁶

On June 22, 1999, Roeder transmitted the twelve-page DROP financial impact report to Larry Grissom. In the cover letter to Larry Grissom, Roeder stated, "[o]ur thought is to keep [the report] in draft form for the time being until there comes a point where we have beaten the subject to death internally and we feel that outside sources of sage advice on this matter have been exhausted."⁷ Roeder went on to note in said letter that "[o]f course, if there is some point prior to early next year where you wish wide distribution of this, just let us know and we will finalize."

The lack of cost neutrality in the City's DROP program was reiterated to SDCERS on September 13, 1999, in a memorandum authored by Roeder entitled "DROP's 'Hidden' Liabilities."⁸ Roeder states in bold letters in said memo that **"In Summary: To the extent that DROP impacts the date of retirement, there will be some cost impact."** [emphasis in original] Additionally, in the memo, Roeder notes that "[i]f DROP continuance next year is problematic due to cost concerns, one minor plan design 'tweak' might be considered: The cost-of-living

⁵ "Evaluating the Financial Impact of DROP, June 17, 1999 (Second Draft)." (Attached hereto as Exhibit 5).

⁶ See letter dated November 18, 1999 from Roeder to Larry Grissom in which Roeder clarifies that "[t]he \$3.6 million cost under the 'total impact' method that we estimated from DROP was for the period from the inception of the DROP program through June 30, 1998." (Attached hereto as Exhibit 6).

⁷ Letter dated June 22, 1999, attached to "Evaluating the Financial Impact of DROP, June 17, 1999 (Second Draft)." (Attached hereto as Exhibit 5).

⁸ DROP's "Hidden" Liabilities, dated September 13, 1999. (Attached hereto as Exhibit 7).

allowances not be considered during the DROP period and in determining the initial pension after the DROP period."

On March 20, 2000, Dan Kelly faxed⁹ to Larry Grissom the "DROP material for Closed Session" and requested the following, "can you help with #'s – comments?" The attached PowerPoint presentation was entitled "Deferred Retirement Option Program / DROP."¹⁰ Under the slide entitled "DROP City Benefits," Dan Kelly requested Larry Grissom's help to fill in the blank in the statement "\$_____ savings since inception of DROP." Additionally, the slide entitled "DROP by the Numbers" has a heading called "CERS Actuarial Impact." That slide, as transmitted from Dan Kelly to Larry Grissom contained no figures relating to "CERS actuarial impact." Furthermore, on the next slide under the heading "Budget Implications," the slide is also blank regarding the budget implications of DROP for FY 1998 through FY 2001.

On the very next day, on March 21, 2000, the slides regarding the cost of DROP in the PowerPoint presentation attached to the March 20, 2000 fax from Dan Kelly to Larry Grissom identified above appeared in a different closed session PowerPoint presentation to the City Council. The topic of that PowerPoint presentation was the status of negotiations with the City's unions and identified the extension of DROP as a topic of the PowerPoint presentation. The slides that previously had blanks for the figures regarding the cost of DROP had now been filled in. In the March 21, 2000, PowerPoint presentation, contrary to all the reports and studies of Roeder, SDCERS actuary, in slide number nineteen, it was reported to the City Council that there had been "\$4.0M savings since inception of DROP." On slide twenty-one, it is reported to the City Council that the City budget saved \$1,300,000 for FY1999, \$1,320,000 for FY2000 and \$1,380,000 for FY2001 as a result of DROP. On slide twenty-two, the City Council is informed that the "general fund saved \$4.0M since inception" of DROP and that the "retirement system absorbed \$4.2M in actuarial impact since inception."¹¹

Thereafter, in that same closed session before Council on March 21, 2000, the City's labor negotiation teams requested an extension for the DROP program to analyze the cost of the DROP program.¹² No reason was provided for the need for an additional year to analyze the cost of DROP. Additionally, no evidence exists to show that the City Council was informed that Roeder had conducted a cost neutrality report and in June 1999 published his conclusion that DROP was not cost neutral. Rather, the City's Labor negotiations team recommended to the City Council to continue DROP for another two years with the direction to then prepare a five-

⁹ Fax transmittal sheet dated March 20, 2000. (Attached hereto as Exhibit 8).

¹⁰ Power Point presentation, attached to fax transmittal sheet dated March 20, 2000. (Attached hereto as Exhibit 8).

¹¹ Power Point presentation, attached to fax transmittal sheet dated March 20, 2000. (Attached hereto as Exhibit 8).

¹² See Closed Session Report dated March 21, 2000 and Power Point presentation attached thereto. (Attached hereto as Exhibit 4).

year evaluation of the DROP program, even though the closed session presentation revealed an actuarial cost impact to the Retirement System.¹³

Even though no cost neutrality study of DROP had been provided to the City and the temporary basis of DROP had been extended so that a study could be performed, the City unions in its labor negotiations in 2000, pushed for the permanence of the DROP program. Specifically, even though on March 21, 2000, the City's labor negotiation teams had requested and received an extension to analyze the cost of the DROP program, the MEA, less than a month later, on April 24, 2000, in its labor proposals for FY2001 and FY 2002 requested that "[r]eferences to the DROP plan as being offered on a 'trial basis' should be eliminated."¹⁴

DROP IS NOT COST NEUTRAL

DROP costs the City in several ways. First, as noted in Roeder's June 1999 study, the total impact evaluation of DROP looked at the total value of the cost or savings, on a present value basis, and determined that there was a cost associated with having the DROP program. Beyond this cost, there are additional costs.

One of the additional costs is that SDCERS has set an interest rate of eight percent (8%) compounded annually on all DROP accounts, including DROP accounts left "on deposit" with SDCERS following a member leaving DROP and City employment. This fact was highlighted in a memorandum dated January 9, 2003 from Ed Ryan, the City's Auditor and Comptroller, to Fred Pierce, President of SDCERS, noting that retirees who are no longer in DROP have been allowed to leave their funds on deposit with SDCERS and are "guaranteed" eight percent (8%) interest compounded annually even when the fund's return is less than eight percent (8%). Mr. Ryan notes that the funds left on deposit on June 30, 2000 amounted to \$3,800,000. This amount grew to \$38,800,000 as of November 30, 2002.¹⁴ Mr. Ryan notes in that memorandum that "[a]s of October 31, 2002, the CERS Trust Fund had net investment losses of over \$50 million and the actuary advised the Fund incurred an actuarial loss of \$313 million for the Fiscal Year ending June 30, 2002. Currently about 250 members who are no longer in DROP have left \$38.8 million in DROP funds on deposit with CERS to earn 8%. At an 8% interest rate the fund is paying out over \$3.1 million annually. The amount on deposit is increasing this fiscal year by an average of \$2 million a month." [emphasis in original]

Local 145 also has the unique ability to increase the cost of DROP to the City. Ordinance 19126 allows a member of that union to convert on a pre-tax basis the cash equivalent of their unused annual leave accrued after July 1, 2002, including annual leave accrued after

¹³ *Id.*

¹⁴ MEA Proposal for FY 2001 & FY 2002 dated April 24, 2000. (Attached hereto as Exhibit 9).

¹⁵ Memorandum dated January 9, 2003 from Ed Ryan to Fred Pierce regarding the subject of "Recommendations for Change in Administration of DROP Program." (Attached hereto as Exhibit 10).

July 1, 2002, while in DROP to extend their DROP participation periods.¹⁶ In other words, even though DROP was specifically limited to a period of five years upon which that person must retire, a firefighter has the ability to extend his/her DROP period by the amount of his/her accrued annual leave. The problem with this part of the ordinance was succinctly stated by Judith Folsom to Councilmember Jim Madaffer in a letter dated February 8, 2003. In that letter, Ms. Folsom informs Councilmember Madaffer that “[i]t is interesting to note that if service purchased in this manner is used for eligibility to enter DROP, the Member’s DROP account will be credited with 8% interest on that portion of the retirement allowance generated by Annual leave conversion for which the System has received no money.”¹⁷ The net effect being that this unique ability to extend a firefighter’s amount of time in DROP costs the City money as that firefighter’s DROP account need now be credited with the amount of annual leave converted for DROP purposes for which he/she will receive a “guaranteed” eight percent (8%) rate of return compounded annually.

If prior to 2004 the City conducted a cost neutrality evaluation regarding DROP, that evaluation cannot be located by anyone. Specifically, on December 30, 2003, Michael Uberuaga sent a memorandum to the Mayor and City Council in which he attaches a brief summary of the City’s retirement benefits, particularly DROP. In that memo, it is asserted that “[a]fter reviewing data prepared by the SDCERS actuary in the spring of 2000, the City concluded that DROP had a cost neutral impact to the City.” However, on Terri Webster’s copy of her memorandum, she writes “? Really, yes – per Cathy [Lexin] ... people remember it, but can’t find anything.” [emphasis in original].¹⁸

As shown above, Roeder clearly made SDCERS aware prior to April 1, 2000 and as early as mid-1999 that DROP was not cost neutral. Indeed, during the “extension” period of DROP, Larry Grissom informed Dan Kelly that the City’s DROP program was not cost neutral. In an e-mail dated February 12, 2001, Larry Grissom writes to Dan Kelly and states that “DROP is intended for the long term member at the end of the career. If you reduce eligibility, you will provide incentive to retire early, which could result in enormous (read really big) actuarial costs.”¹⁹ Larry Grissom couldn’t have been more correct in his assertion as that is exactly what has happened with the City’s DROP program.

¹⁶ Ordinance 19126 adopted on June 18, 2002, page 4. (Attached hereto as Exhibit 11).

¹⁷ Letter from Judith Folsom to Council Member Jim Madaffer dated February 8, 2003. (Attached hereto as Exhibit 12).

¹⁸ Memorandum to the Honorable Mayor and City Council dated December 30, 2003 regarding the subject of “Facts Related to the City’s Retirement Benefits/Deferred Option Plan” taken from the files of Terri Webster. (Attached hereto as Exhibit 13).

¹⁹ E-mail dated February 12, 2001 from Lawrence Grissom to ddk regarding the subject of “issues.” (Attached hereto as Exhibit 14).

THE AUDIT BY AN INDEPENDENT THIRD PARTY REVEALS THAT DROP IS NOT COST NEUTRAL

In or around May 2004, Mercer performed an audit of the actuarial work of SDCERS. On September 22, 2004, Mercer issued a second addendum to the audit. In that addendum, Mercer states that “[b]ased on our evaluation, for Safety members, the DROP program is not cost-neutral. The value of the DROP benefit is 115 percent of the value of the benefit he would have earned by continuing to accrue service and pay increases.” As for general members, Mercer states in their report that “[f]or the average general member entering DROP, the ratio of the benefit value including DROP to the benefit value if the member didn’t enter DROP is 111 percent at the end of the maximum DROP period.”²⁰

On December 7, 2004, Roeder issued a memorandum entitled “Evaluating the Financial Impact of DROP.” In that memorandum, Roeder states their agreement with Mercer’s assessment that DROP is not cost neutral.²¹

DROP AFFECTS THE VALUATION OF THE SDCERS FUND

In addition to an actual cost of the DROP program, SDCERS has long recognized that it affects the valuation of the system as both the assets and liabilities of DROP are not included in the system’s valuation.²² Further, SDCERS recognized that while the crediting of an annual eight percent rate of return to system benefits could be reduced, SDCERS felt it could not similarly do that to DROP accounts, which represents a cost to the DROP program if the overall investment in the fund does not cover the guaranteed eight percent annual return on every DROP account. This actual cost was accurately described in a letter from Auditor Ed Ryan wherein he classified the cost as a system subsidy to the DROP program, with a substantial and negative cost to the City and the system.²³

Subsequently, an SDCERS employee recognized the possibility of DROP program cost by communicating the concern that the continuation of the eight percent annual credit to DROP accounts was a drain on system reserves and that its continuation would either result in an inability to fund other benefits (i.e., 13th checks and Corbett payments) or an increase in the

²⁰ Second Addendum to Audit of Actuarial Work San Diego City Employees’ Retirement System, dated September 22, 2004 and prepared by Mercer. (Attached hereto as Exhibit 15).

²¹ Evaluating the Financial Impact of DROP City of San Diego, dated December 7, 2004 and prepared by Roeder. (Attached hereto as Exhibit 16).

²² SDCERS’ Retirement Board Minutes, dated April 19, 2002, page 23. (Attached hereto as Exhibit 17).

²³ Undated letter from Auditor Ed Ryan and Mike Uberuaga to “Fred.” (Attached hereto as Exhibit 18).

UAAL.²⁴ This concern was echoed by other City officials with the further expressed concern of the program's drain on system assets due to the system not earning what it was paying to the DROP accounts in interest.²⁵

THE CITY'S ACTUARY OPINES THAT DROP IS NOT COST NEUTRAL AND HAS NOT BEEN SINCE INCEPTION

Joseph Esuchanko, the actuary the City has hired to consult on actuarial matters relating to the pension system, has now opined that DROP is not cost neutral in a nine page opinion.²⁶ Using data available to Mr. Esuchanko, Mr. Esuchanko has estimated the costs of DROP to those SDCERS members currently participating in DROP to be \$43,595,350. This number represents approximately only those persons currently participating in DROP and represents approximately sixty percent of all persons who have participated in DROP since its inception. Extrapolating that figure out to include all current and past DROP participants, Mr. Esuchanko concluded that the cost to the City will be approximately \$72,500,000.²⁷

Mr. Esuchanko has also estimated the present value, as of June 30, 2005, of the DROP costs attributable to future DROP participants who are currently active members to be \$120,000,000.²⁸ Therefore, the total estimated total present value of all costs attributable to DROP for all past and current SDCERS members is \$192,500,000.

Even though DROP was implemented as a means to retain experienced and more highly paid workers, definition, the City's payroll expenses are increased as highly compensated employees remain on the City's payroll for up to an additional five years. Therefore, comparing the average salary of a member currently participating in DROP to that of the average salary of a recent new hire (and taking into account the total increase of payroll due to the probable promotion of multiple persons caused by the retirement), Mr. Esuchanko has been able to estimate the present value of the increased future payroll costs. That cost is estimated to be an additional sum of \$210,000,000.²⁹

²⁴ Email from Judy Folsom dated January 13, 2003. (Attached hereto as Exhibit 19).

²⁵ Undated memo regarding DROP. (Attached hereto as Exhibit 20).

²⁶ DROP Cost Neutrality Opinion, prepared by Actuarial Service Company, P.C. (Attached hereto as Exhibit 21).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.* at page 9.

In sum, contrary to the concept that the City experiences savings to due to reduced City contributions, no such savings for the City have occurred.³⁰ When a person enters DROP, his/her liabilities actually increase.³¹ Additionally, this increase in liability is unfunded.³² Thus, these costs will be paid in future increased amortization contribution rates applied to the remaining active members.³³ Accordingly, to date, Mr. Esuchanko has estimated the total increased costs to the City due to the creation of DROP to be \$400,000,000.³⁴

DROP CONTINUES TODAY EVEN THOUGH ALL EVIDENCE SHOWS IT TO BE NON-COST NEUTRAL

The DROP program exists and is administered unabated even though the requisite actuarial cost-neutral determination has never been done and to the contrary, all reports and analyses have determined that there is a net cost to the City. To date there is no evidence that any such definitive determination of actuarial cost-neutrality has been made.³⁵

Not only is the historical record clear that the cost-neutral actuarial study necessary for the DROP program to continue beyond its three-year trial period never occurred and that all reviews have been to the contrary, it remains clear as of this date that the DROP program is not cost-neutral.

CONCLUSION

The lack of the existence of a cost-neutral actuarial determination of the DROP program is not only inconsistent with continuation of the DROP program beyond its initial trial basis term of three years, but the DROP program has served as a catalyst for increased costs to the City. This increased cost since DROP's inception has added to the UAAL and increases the contributions that must be made by the City every year.

By its own terms, Section 24.1401 should have been repealed on or about April 2000, thereby precluding the continuation of the DROP benefit. Even by sheer neglect, in light of the universal opinion of lack of cost-neutrality, minimally, it should have been eliminated at some

³⁰ *Id.* at page 8.

³¹ *Id.*

³² *Id.*


³³ *Id.*

³⁴ *Id.* at page 9.

³⁵ There are several "DROP-proponent" memoranda and reports from various City Manager staff, none of which qualify as an actuarial evaluation as required by O-18385.

point. The continuance of the DROP program in the face of the lack of any cost-neutral study and the wealth of evidence to the contrary was illegal and in contravention of the express terms of the ordinance creating Section 24.1401. Accordingly, the DROP program must be eliminated through its repeal of Section 24.1401, *et seq.*³⁶ Attached is the necessary ordinance to immediately repeal the DROP program.

MICHAEL J. AGUIRRE



City Attorney

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RC-2007-3
(Re: O-2007-94)

³⁶ The repeal of section 24.1401 would not be subject to meet and confer with the recognized employee labor organizations as its perpetuation as a benefit beyond the trial period ending in March, 2000 was without legal basis. Thus, there is no matter to negotiate.